

June 8, 2020

Update for Chinese SEC Reporting Companies: President Trump Mandates Report on PCAOB Access and Investor Protections

We previously reported (see our May 26 alert [available here](#)) on various actions taken in May by the U.S. Senate and by Nasdaq to address the longstanding issue of access by U.S. regulators to information relating to Chinese companies¹ listed in the United States and, in particular, access by the Public Company Accounting Oversight Board (the “PCAOB”) to work papers relating to the audits of the financial statements of such companies and its ability to conduct on-site inspections of auditors. On June 4, President Trump issued a Presidential Memorandum ([available here](#)) in which he directs his Working Group on Financial Markets to discuss, and issue within 60 days a report on, the PCAOB access issue as well as investor protections more broadly. This update addresses the Presidential Memorandum.

Background

Any company listed in the United States must be an SEC reporting company, and the audit of the financial statements of any such reporting company must be conducted by a firm (whether a U.S. auditor or a non-U.S. auditor) registered with, and subject to the jurisdiction of, the PCAOB. PCAOB registration includes undergoing regular PCAOB inspections to assess auditor compliance with legal and professional standards. PCAOB inspections may result in the identification of deficiencies in one or more of an audit firm’s audits and/or in its quality control procedures. These, in turn, can result in an audit firm carrying out additional procedures that should have been performed at the time of the audit. Those procedures have sometimes led to the audited public company having to revise and refile its financial statements or its assessment of the effectiveness of its internal control over financial reporting.

The issue of PCAOB access is by no means new, and more recently has become enmeshed in a broader concern on the part of the SEC, in particular over disclosure and financial reporting practices in jurisdictions where U.S. regulators have little or no access. In 2013, a Memorandum of Understanding was signed by the PCAOB and Chinese authorities addressing enforcement cooperation. Since then, however, the PCAOB has faced continued difficulties in getting timely access to documents and testimony from PCAOB-registered auditors based in China that are auditing the financial statements of Chinese companies listed in the United States. In an update provided at the end of 2018 ([available here](#)), the PCAOB noted that it and the SEC continue to face challenges in overseeing financial reporting by companies whose operations

¹ For this purpose, we include companies incorporated in the Cayman Islands or other offshore jurisdictions that are holding companies for businesses and operations that are primarily based in China, including through variable interest entity structures.

are based in China, in that business books and records related to transactions and events occurring within China are required by Chinese law to be kept and maintained in China and China restricts auditor work papers for audits performed in China from being transferred out of China. China's state security laws are invoked, at times, to limit U.S. regulators' ability to oversee financial reporting of China-based companies. The SEC staff issued a similar statement at the same time ([available here](#)). A separate, and perhaps more difficult, challenge is that the PCAOB is restricted from inspecting audit work and practices of PCAOB-registered audit firms in China (including Hong Kong-based audit firms, to the extent their audit clients have operations in mainland China) with respect to their audit work for U.S. listed companies with operations in China.

The most forceful articulation of the concerns were set out in an April 21, 2020 Public Statement by the Chairman of the SEC and the PCAOB Chairman, and other senior SEC staff members ([available here](#)). SEC Chairman Clayton announced in early May that the SEC would convene a roundtable to discuss emerging market issues; the date for that meeting has been set as July 9. The agenda is to include:

- the limited ability of U.S. regulators to inspect for compliance and enforce U.S. laws;
- the quality of information and risk disclosure for emerging market issuers;
- the PCAOB's inability to inspect audit papers in China;
- auditors' global oversight of member firms in emerging markets;
- the role of index providers and other passive investment strategies;
- obligations of financial professionals in making recommendations for emerging market issuers; and
- potential future additional remedial actions (a range of which have been suggested), and the potential collateral consequences of those actions.

U.S. Senate and Nasdaq Actions

On May 20, the U.S. Senate passed the Holding Foreign Companies Accountable Act ([available here](#)) that, in effect, could result in the delisting of non-U.S. reporting companies (particularly from China) whose financial statements have, for a period of three consecutive years, been audited by an accounting firm branch or office that is not subject to PCAOB inspection.

On May 18, Nasdaq proposed to amend its rules (IM-5101-1) to codify its existing discretionary authority under Rule 5101 over initial and ongoing listing requirements, by adding certain factors that would assist Nasdaq in determining whether to apply additional and more stringent criteria to an applicant or listed company based on the qualifications of the company's auditor, including whether it has been, or can be, subject to PCAOB inspection. The text of the proposed amendments is [available here](#).

Presidential Memorandum

The June 4 Presidential Memorandum is addressed to the Secretary of the Treasury, the Assistant to the President For Economic Policy and the Assistant to the President For National Security Affairs, and calls on the President's Working Group on Financial Markets² to discuss, and issue within 60 days a report on, the PCAOB access issue as well as investor protections more broadly. The report is to cover recommendations for:

- actions the executive branch may take to protect investors in U.S. financial markets from the failure of the Chinese government to allow PCAOB-registered audit firms to comply with U.S. securities laws and investor protections;
- actions the SEC or PCAOB should take, including inspection or enforcement actions, with respect to PCAOB-registered audit firms that fail to provide requested audit working papers or otherwise fail to comply with U.S. securities laws; and
- additional actions the SEC or any other federal agency or department should take as a means to protect investors in Chinese companies, or companies from other countries that do not comply with U.S. securities laws and investor protections, including initiating a notice of proposed rulemaking that would set new listing rules or governance safeguards. Any such actions should take into account the impact on investors and ensure the continued fair and orderly operation of U.S. financial markets.

Concurrently, the Secretary of State, in a press release ([available here](#)) endorsed the proposed Nasdaq restrictions.

Concluding Thoughts

It is difficult to predict what Chinese companies listed in the United States will face at the end of this process. As of April 1, there were 265 SEC reporting companies on the PCAOB's list of companies from jurisdictions where PCAOB access to conduct inspections is denied (all but 23 have auditors located in China or Hong Kong, the balance being in Belgium and France). There is a larger political backdrop to these issues, which needs to be factored into any assessment of likely outcomes.

We continue to monitor the situation. In the meantime, Chinese reporting companies that have yet to file their annual reports on Form 20-F should revisit their risk factor disclosures to update for these recent developments and those with upcoming analyst/investor calls should be prepared for questions as to potential implications and fallback plans. For market participants, the potential consequences of the actions

² The Working Group is chaired by the Secretary of the Treasury, or his designee, and includes the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the SEC and the Chairman of the Commodity Futures Trading Commission, or their designees.

described above undoubtedly will need to be considered in the context of the broader political and geopolitical tensions between the United States and China.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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